Economic Insights

U.S.–China Trade: More Than a Game of Chicken

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Now that the U.S. Senate has fired what might be the first salvo in a trade war with China, investors, already beset by a host of uncertainties, must consider another—this one is possibly the most dangerous of all. If Congress can label China a “currency manipulator,” then tariffs aimed at China become likely, as does Chinese retaliation in a pattern that would hurt world trade, growth prospects in both countries, and asset values on both sides of the ocean and beyond. Of course, the Senate’s recent vote is still a ways from legislation, much less law, but the dangers here are so profound they demand a consideration of the potential pitfalls.

The hope here—indeed, the reasonable expectation—is that this recent vote is just posturing. Both houses of Congress, as well as the White House, regardless of the party in power, have a history of playing to the populist, protectionist galleries while following a more moderate legislative line. The Senate, after all, has only just voted to begin debate and might still refuse to start the process. The Republican-dominated House of Representatives is even less likely to proceed on such a path. Republicans traditionally have shown a greater reluctance to engage in any restraint of international trade than have Democrats—except that the Tea Party has thrown a wild card into this congressional shuffle. President Barack Obama has already voiced concerns about the recent Senate vote, but having imposed tariffs of his own not too long ago, there is no telling how he will lean if a bill arrives on his desk, especially in an election year.

There can be little doubt that China would retaliate should the United States go down this path. When in 2009 President Obama bowed to the demands of the United Steel Workers of America and imposed a 35% tariff on tire imports from China, Beijing within days announced a review of American chicken and auto parts imports. Though the Chinese announcement failed to mention the tire tariffs, it was surely in response. After all, the sum of the American chicken and auto part sales in China exactly equaled the $1.3 billion involved in Chinese tire exports to the United States. When, subsequently, the White House announced 145% duties on Chinese steel, Beijing in early 2010 slapped a 105.4% duty on American chicken imports and further duties on American auto parts as well.

Either economy could easily absorb an exchange limited to tires, chickens, and some auto parts, but the prospect of something more general raises the ante considerably. General tariffs on Chinese imports, something like the 27.5% long proposed by senators Chuck Schumer (D-NY) and Lindsey Graham (R-SC), would at the very least raise costs to American consumers and depress living standards accordingly, especially for those at the low end of the income distribution, where inexpensive Chinese goods often dominate. Beyond consumers, the duties would also impose greater costs on all those producers who use Chinese imports—whether steel, tires, plastics, or any other intermediate good as an input in their processes—spreading the pain to many who never directly buy Chinese goods. It is noteworthy, for instance, that when President Obama imposed a duty on tires, the loudest protests came from both auto manufacturers and the auto workers’ union. Similar resistance arose years ago, and for the same reasons, when auto and appliance manufacturers objected to President George W. Bush’s steel tariffs in 2002.

For all this pain, it is not even clear that those presumably protected by such a tariff wall would actually benefit. Many other emerging economies—India, Vietnam, Indonesia, and even the old Asian “tigers”—would eagerly step into China’s place, and if these economies compete less fiercely than the Chinese, their entry into the market would blunt or erase any benefit the tariffs might offer domestic producers, their profits, and their job creation. All the pain, then, for American consumers and producers who use Chinese goods would occur to the benefit of other emerging economies, not China’s domestic competitors.

And if China retaliated, as it almost surely would, the strains would be that much greater. Such action would, of course, hit any American firms and workers who derive income from sales in China. The United States may run a trade deficit with China, but that fact should not obscure the almost $100 billion in products this country sells to China each year and, of course, the jobs and profits that are tied to these sales. What makes matters even more dangerous is that trade wars, once they begin, tend to suck in more than just the countries initially involved. The classic example of this hugely destructive potential is the Smoot-Hawley tariff of 1930, which surely extended and deepened the Great Depression.

Back then, Senator Reed Smoot (R-UT) and Representative Willis Hawley (R-OR) meant well when they proposed their tariffs. They were troubled by the economic dislocations that followed the stock market crash of 1929 and thought they could protect American jobs by placing duties, averaging 20%, on 20,000 different imports. What they got instead turned out to be a disaster for the United States and the world. The rising cost of living as a consequence of the tariff hurt the American wage earner, especially since wages at that time were already in decline. Meanwhile, a host of other countries retaliated. The League of Nations, the world's premier international body at the time, noted with dismay how Smoot-Hawley was "the signal for an outburst of tariff making" that compounded the world's already severe economic problems. World trade fell 67% in the two years following the bill's passage. Though American imports fell 40%, exports fell 75%. The effect, it might be argued, destroyed a nascent recovery. Though the U.S. economy fell into recession right after the stock market crash of 1929, it had begun a recovery in 1930. Unemployment, 9% in January of that year, had fallen to 6.3% in June. But that improvement reversed as soon as the tariffs passed into law. Investors clearly saw the danger. Stocks fell 10% on the day President Herbert Hoover signed Smoot-Hawley. The economic decline lasted until 1932, and unemployment rose to exceed 25% of the available work force.

To be sure, investors today are a long way from such a horrific prospect. The legislation contemplated at the movement is less severe than Smoot-Hawley and is still far from law. There is ample reason to expect cooler heads to prevail, both in Washington and in Beijing, so that each country and the world can avoid the pain of such a mistake. But the Senate's recent vote has, nonetheless, raised a huge risk in an already uncertainty-filled investment climate. On that basis, it is a matter of concern to all investors. Sometimes, Washington seems determined to hold back economic growth and stifle job creation.

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